THE ECONOMIC AND BUDGET OUTLOOK: AN UPDATE

A Report to the
Senate and House
Committees on the Budget

As Required by Public Law 93-344

The Congress of the United States
Congressional Budget Office

NOTES

Unless otherwise indicated, all years referred to in Chapter 1 are calendar years and all years in Chapter 2 are fiscal years.

Some figures in this report indicate periods of recession using shaded vertical bars. The bars extend from the peak to the trough of the recession.

Unemployment rates throughout the report are calculated on the basis of the civilian labor force.

Numbers in the text and tables of this report may not add to totals because of rounding.

National income and product account data shown in the tables do not incorporate the July 29, 1994, revisions, which did not significantly affect the economic outlook. The discussion in Chapter 1 does, however, take account of the revisions.

For sale by the U.S. Government Printing Office
Superintendent of Documents, Mail Stop: SSOP, Washington, DC 20402-9328
ISBN 0-16-045157-4

Preface

This volume is one of a series of reports on the state of the economy and the budget that the Congressional Budget Office (CBO) issues each year. It satisfies the requirement of section 202(f) of the Congressional Budget Act of 1974 for CBO to submit periodic reports to the Committees on the Budget with respect to fiscal policy. In accordance with CBO's mandate to provide objective and impartial analysis, the report contains no recommendations.

The analysis of the economic outlook presented in Chapter 1 was prepared by the Macroeconomic Analysis Division under the direction of Robert Dennis and John F. Peterson. Adrienne Kearney wrote the chapter, with contributions from Robert Arnold, Laurie Brown, Kim Kowalewski, Frank Russek, Jr., Matthew Salomon, and Christopher Williams. Matthew Salomon carried out the economic forecast and projections. Douglas Elmendorf, Victoria Farrell, Douglas Hamilton, Thomas Loo, Joyce Manchester, Angelo Mascaro, and John Sturrock provided comments and background analysis. Derek Briggs, Laurie Brown, Blake Mackey, John Romley, and Michael Simpson provided research assistance.

The baseline outlay projections were prepared by the staff of the Budget Analysis Division under the supervision of C.G. Nuckols, Paul N. Van de Water, Paul Cullinan, James Horney, Michael Miller, and Robert Sunshine. The revenue estimates were prepared by the staff of the Tax Analysis Division under the supervision of Rosemary Marcuss and Richard Kasten. Kathy A. Ruffing wrote Chapter 2 with contributions from Bryan Grote, Jeffrey Holland, and Richard Kasten. Matthew Salomon wrote Appendix A with Laurie Brown, and Robert Arnold wrote Appendix B. James Horney wrote the summary of the report.

An early version of the economic forecast underlying this report was discussed at a meeting of CBO's Panel of Economic Advisers. Members of this panel are Michael Boskin, Barry Bosworth, Robert Dederick, Martin Feldstein, Benjamin Friedman, Lyle E. Gramley, Robert Hall, Lawrence Klein, Robert Lawrence, John Makin, Burton Malkiel, Rudolph Penner, William Poole, Paul Samuelson, Charles Schultze, Robert Solow, James Tobin, Murray Weidenbaum, and Janet Yellen. Robert Gordon, Andrew Harless, James Medoff, Laurence Meyer, Michael Moran, and Edmund Phelps attended as guests. Although these outside advisers provided considerable assistance, this document does not necessarily reflect their views.

Paul L. Houts supervised the editing and production of the report, assisted by Sherry Snyder. Major portions were edited by Paul L. Houts, Sherry Snyder, Sherwood Kohn, and Christian Spoor, with the assistance of Leah Mazade. Laurie Brown prepared the graphics for Chapter 1 and Appendix B. Marion Curry, Dorothy Kornegay, Linda Lewis, and L. Rae Roy assisted in the preparation and production of the report. With the assistance of Martina Wojak-Piotrow, Kathryn Quattrone prepared the report for final publication.

Robert D. Reischauer
Director

August 1994

Contents

TABLES

FIGURES

BOXES

Summary

The Congressional Budget Office (CBO) projects higher economic output and lower deficits in 1994 and 1995 than were anticipated last winter. In the longer run, however, there is little change in the expected levels of gross domestic product (GDP) or deficits. Based on strong economic growth since the third quarter of 1993 and an expected continuation of high levels of business investment and consumer spending, CBO has pushed its forecast of real growth in calendar year 1994 up to 3.6 percent--almost 1 percentage point higher than the previous forecast. In addition to swelling the forecast levels of GDP in 1994 and 1995, this unexpected growth has raised CBO's projections of interest rates and consumer prices throughout the projection period. It has not, however, significantly affected the estimate of potential GDP or the projection of GDP for 1999.

CBO's baseline deficits will fall to $202 billion in fiscal year 1994 and to $162 billion in 1995--respectively $26 billion and $17 billion lower than the winter baseline projections. Unfortunately, the short-term improvement in the deficit outlook does not signal any brightening of long-term deficit prospects. CBO still projects that the deficit will begin to grow again--slowly in 1996 and more rapidly at the end of the decade. By 1999, the deficit is expected to reach $231 billion, somewhat higher than the $213 billion projected in the winter. CBO's less detailed 10-year budget projections indicate that deficits will continue to grow after 1999, and there is no reason to believe that the trend will be reversed after 2004 under current laws and budgetary policies.

The Economic Outlook

CBO's economic forecast reflects higher growth in the short term than was envisioned in the winter forecast of *The Economic and Budget Outlook: Fiscal Years 1995-1999*, published in January 1994. This unexpectedly strong growth has pushed up anticipated interest rates and consumer prices but has had little effect on CBO's projection of the size of the economy in 1999, the last year of the projection period.

The Forecast for 1994 and 1995

CBO forecasts that real GDP will grow by 3.6 percent in 1994 and 2.7 percent in 1995, on a fourth-quarter-to-fourth-quarter basis (see Summary Table 1). The growth rate for 1994 is almost 1 percentage point higher than was anticipated last winter. The increase is prompted by the strong growth recorded since the third quarter of 1993 and CBO's assessment that the factors driving that surge--business investment in plant and equipment and consumer spending for such durable goods as automobiles--will continue to spur growth through the middle of 1995.

As a result of the rapid growth in 1994, CBO and most other economic forecasters agree that the GDP is near potential output (the level of real GDP that is consistent with a stable rate of inflation). The other forecasters are divided, however, over the

Summary Table 1.
Short-Term Economic Forecasts for 1994 and 1995

	1993	Forecast 1994	Forecast 1995
	Fourth Quarter to Fourth Quarter (Percentage change)		
Nominal GDP			
CBO summer	5.4	6.2	5.3
Administration	5.4	5.8	5.6
Blue Chip	5.4	5.9	5.8
CBO winter	4.9	5.7	5.4
Real GDP			
CBO summer	3.1	3.6	2.7
Administration	3.1	3.0	2.7
Blue Chip	3.1	3.1	2.6
CBO winter	2.3	2.8	2.7
Consumer Price Index[a]			
CBO summer	2.7	2.8	3.2
Administration	2.7	2.9	3.2
Blue Chip	2.7	2.8	3.4
CBO winter	2.7	2.9	3.0
	Calendar Year Averages (Percent)		
Civilian Unemployment Rate[b]			
CBO summer	*6.8*	6.2	5.8
Administration	*6.8*	6.3	6.2
Blue Chip	*6.8*	6.3	6.0
CBO winter	*6.8*	6.6	6.4
Three-Month Treasury Bill Rate			
CBO summer	3.0	4.1	5.5
Administration	3.0	4.0	4.7
Blue Chip	3.0	4.0	4.8
CBO winter	3.0	3.5	4.3
Ten-Year Treasury Note Rate			
CBO summer	5.9	6.8	6.8
Administration	5.9	6.8	7.0
Blue Chip[c]	5.9	6.8	7.2
CBO winter	5.9	5.8	6.0

SOURCE: Congressional Budget Office; Office of Management and Budget, *Mid-Session Review of the 1995 Budget* (July 1994); Eggert Economic Enterprises, Inc., *Blue Chip Economic Indicators* (July 10, 1994).

a. The consumer price index for all urban consumers.

b. The Bureau of Labor Statistics changed the unemployment survey in January 1994. The CBO summer forecast for 1994 and 1995 uses the new survey method. The CBO winter forecast for those years has been adjusted upward by one-quarter of a percentage point to make the forecasts comparable. Data for 1993 (shown in italics) use pre-1994 methodology.

c. *Blue Chip* does not project a 10-year note rate. The values shown here are based on the *Blue Chip* projection of the Aaa bond rate, adjusted by CBO to reflect the estimated spread between Aaa bonds and 10-year Treasury notes.

likely path of the economy from this point. Some anticipate that momentum will push actual GDP well above potential, triggering a big increase in inflation and a spike in short-term interest rates similar to that experienced at the end of every postwar expansion in the United States. Other forecasters believe that the growth of demand is already running out of steam and that GDP will settle into a path just below potential output without much further action by the Federal Reserve to raise short-term interest rates.

CBO's forecast charts a middle course. Real GDP barely exceeds potential output and by the end of 1995 is beginning to fall back. Interest rates on three-month Treasury bills are expected to increase from the unusually low rate of 3.0 percent in 1993 to 4.1 percent in 1994 and 5.5 percent in 1995. In the absence of any unanticipated supply shocks, the fourth-quarter-to-fourth-quarter increase in the consumer price index will grow from 2.7 percent in 1993 to 2.8 percent in 1994 and 3.2 percent in 1995. Although greater than anticipated in the winter, these increases in inflation and short-term interest rates are smaller than those experienced at the end of previous postwar expansions.

The Congressional Budget Office believes that the turbulence associated with mature expansions in the past is not likely to develop in 1994 and 1995 because of the moderate progression of the current expansion, early action by the Federal Reserve to restrain inflationary pressures, and the low probability of a significant supply shock (such as the oil price hikes that occurred as expansions were ending in the 1970s). The *Blue Chip* consensus of private forecasters and the Administration's July 1994 *Mid-Session Review* forecast also assume that the economy in 1994 and 1995 will not exhibit the spike in interest rates and in inflation associated with mature expansions in the past. In fact, they assume significantly lower real growth in 1994 and lower short-term interest rates in 1995 than does CBO--assumptions more in line with the smooth-landing scenario that predicts growth will gently level off near potential output.

The unemployment rate is a key variable in assessing the state of the economy, but current data on unemployment are difficult to interpret because of a change in survey methodology introduced by the Bureau of Labor Statistics last January. Nonetheless, it is clear that unemployment has fallen faster than CBO anticipated last winter. The CBO forecast assumes that the unemployment rate will continue to fall--to 6.2 percent in 1994 and 5.8 percent in 1995 (based on the new methodology). At 5.8 percent, unemployment will be below CBO's current estimate of the nonaccelerating inflation rate of unemployment (NAIRU--the minimum rate of unemployment consistent with a stable rate of inflation). A projected unemployment rate lower than the NAIRU is one sign of the slow buildup of inflationary pressures that is reflected in the Congressional Budget Office's forecast.

Projections for 1996 Through 1999

The Congressional Budget Office does not attempt to forecast cyclical fluctuations in the economy more than two years into the future. Beyond two years, CBO projects a course for the economy that will bring GDP for the last year of the projection period (1999 in this case) to a level--consistent with the average historical relationship between actual and potential GDP--slightly below estimated potential output. The estimate of potential gross domestic product is based on an analysis of such fundamental factors as growth in the labor force, productivity, and national saving.

The increase in the growth forecast for 1994 did not cause CBO to change its winter estimate that potential GDP would grow at an average rate of 2.4 percent a year during the 1996-1999 projection period. It did, however, push the level of real GDP forecast for 1995--the starting point for the 1996-1999 projections--above potential. Therefore, in order to allow projected GDP to fall to its historical relationship with potential output in 1999, CBO reduced the projected average annual growth of real GDP between 1995 and 1999 from 2.6 percent to 2.2 percent (see Summary Table 2).

The projection assumes that the interest rate on three-month Treasury bills will fall from 5.5 percent in 1995 to 5.1 percent in 1996 and 4.9 percent for the rest of the projection period. The projected interest rate for 10-year Treasury notes is 6.5 percent throughout the 1996-1999 period, down from 6.8 percent in 1995. Both the short- and long-term rates are somewhat higher than those projected in the winter. The annual increase in the consumer price index is expected to grow from 3.1 percent in 1995 to 3.4 percent a year after 1996, up from the peak rate of 3.1 percent in the winter projections. The unemployment rate is expected to increase slightly after 1995, leveling off at 6.1 percent in 1998 and 1999.

The Budget Outlook

The Congressional Budget Office projects that the deficit will fall faster in fiscal years 1994 and 1995 than was anticipated in the winter baseline, published as Appendix A in CBO's April 1994 report, *An Analysis of the President's Budgetary Proposals.* There is little change, however, in the long-term budget outlook; the deficit will still begin growing after 1995, and by 1999 the projected deficit will be slightly higher than had been estimated in the winter baseline.

The Outlook for the Deficit

CBO's baseline projections assume that the Congress makes no changes in current law and policies that affect tax revenues and mandatory spending. They also assume compliance with the discretionary spending limits set in the Budget Enforcement Act

Summary Table 2.
Medium-Term Economic Projections (By calendar year)

	Actual	Forecast		Projected			
	1993	1994	1995	1996	1997	1998	1999
Nominal GDP (Billions of dollars)	6,378	6,777	7,161	7,523	7,893	8,277	8,687
Real GDP (Billions of 1987 dollars)	5,136	5,343	5,505	5,635	5,756	5,878	6,009
Real GDP (Percentage change)	3.0	4.0	3.0	2.4	2.1	2.1	2.2
Implicit GDP Deflator (Percentage change)	2.5	2.2	2.5	2.6	2.7	2.7	2.7
CPI-U (Percentage change)	3.0	2.6	3.1	3.3	3.4	3.4	3.4
Unemployment Rate (Percent)	6.8	6.2	5.8	5.9	6.0	6.1	6.1
Three-Month Treasury Bill Rate (Percent)	3.0	4.1	5.5	5.1	4.9	4.9	4.9
Ten-Year Treasury Note Rate (Percent)	5.9	6.8	6.8	6.5	6.5	6.5	6.5

SOURCE: Congressional Budget Office.

NOTE: CPI-U is the consumer price index for all urban consumers.

of 1990 (for 1995) and in the Omnibus Budget Reconciliation Act of 1993 (OBRA-93, for 1996, 1997, and 1998), which allow outlays to increase by less than $3 billion between 1994 and 1998--a cut of more than 10 percent in constant dollars. CBO assumes that discretionary spending will grow at the same pace as inflation after 1998, when the discretionary caps have expired.

CBO projects that the baseline deficit will decline to $202 billion in 1994 and $162 billion in 1995 (see Summary Table 3). The $162 billion represents the lowest deficit since 1989 and the lowest deficit as a percentage of GDP (2.3 percent) since 1979. It also represents a $128 billion reduction below the record-high deficit of $290 billion posted in 1992. As recently as March 1993, CBO projected that the 1995 deficit would be only a few billion dollars below that record-high level. The improved outlook for 1994 is the result of policy changes enacted in OBRA-93, economic performance that has been better than anticipated, and reestimates of spending and revenues for a variety of technical reasons. The policy changes account for a little less than half of the improvement in the 1995 deficit.

The same factors that have pushed down the projected level of the 1995 deficit since March 1993 have also reduced the deficits for other years. The currently projected deficit for 1998 is more than $160 billion lower than was anticipated in March 1993. The policy changes enacted in OBRA-93 account for almost 90 percent of the reduction, and the rest is attributable to a strengthening of projected economic performance. These factors have not, however, altered the underlying trend of deficits that, after falling from the high levels of the early 1990s, rise steadily as the decade draws to a close. CBO projects that the deficit will grow at an average rate of more than 9 percent a year between 1995 and 1999, reaching $231 billion in 1999.

Summary Table 3.
CBO Deficit Projections (By fiscal year)

	1993	1994	1995	1996	1997	1998	1999
			In Billions of Dollars				
Total Deficit	255	202	162	176	193	197	231
Standardized-Employment Deficit[a]	221	184	183	195	200	196	223
			As a Percentage of GDP				
Total Deficit	4.0	3.0	2.3	2.4	2.5	2.4	2.7
Standardized-Employment Deficit[b]	3.4	2.7	2.6	2.6	2.6	2.4	2.6
Memorandum: Gross Domestic Product (Billions of dollars)	6,295	6,677	7,070	7,431	7,800	8,179	8,581

SOURCE: Congressional Budget Office.

a. Excludes the cyclical deficit and deposit insurance spending.

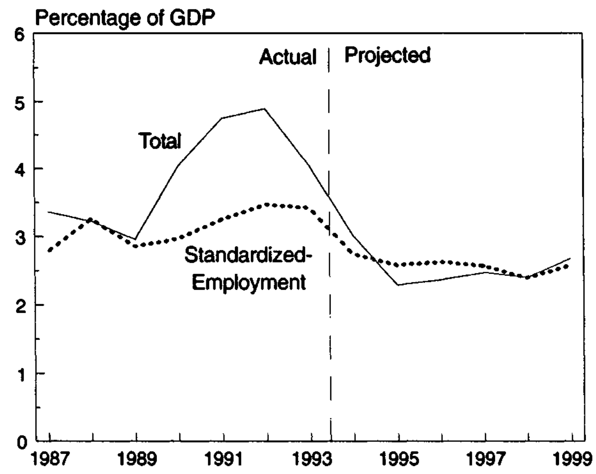
b. Expressed as a percentage of potential GDP.

Since nominal GDP is expected to grow at an average annual rate of about 5 percent during the same period, the deficit will increase as a percentage of GDP from 2.3 percent in 1995 to 2.7 percent in 1999 (see Summary Figure 1).

Part of the fluctuation in deficits is the result of cyclical changes in the economy. Revenues tend to be lower and outlays higher when the economy is performing below potential. The opposite occurs when actual output exceeds potential. The standardized-employment deficit is a measure of the difference between revenues and outlays that would occur if the economy were operating at potential (it also excludes the net expenditures of deposit insurance agencies and the Desert Storm contributions received in the early 1990s). Taken as a percentage of potential GDP, this measure also declines from high levels in the early 1990s, flattens out, and then begins rising at the end of the decade. Debt held by the public, as a percentage of GDP, follows a similar path.

CBO's abbreviated projections for the 2000-2004 period indicate that under current laws and budgetary policies the growth in deficits experienced at the end of the 1990s will continue, with the deficit equaling 3.6 percent of GDP in 2004.

Summary Figure 1.
The Federal Deficit (By fiscal year)



SOURCE: Congressional Budget Office.

There is no reason to assume that the trend will be reversed after 2004 unless policies are changed. In fact, additional pressures on federal spending, when baby boomers start becoming eligible in large numbers for Social Security and Medicare benefits around 2010, are likely to increase the growth of deficits.

The growth in the projected deficit after 1995 will continue to be driven by the increasing costs of the two major federal health care programs: Medicare and Medicaid. These two programs together will grow at an average annual rate of approximately 11 percent from 1995 to 1999, all other outlays will increase at a rate of less than 4 percent, and revenues will increase at almost the same rate as GDP. If increases in spending for Medicare and Medicaid were more in line with the growth of other outlays, the deficit would not grow as a percentage of GDP. Comprehensive reform of the nation's health care system, currently being considered by the Congress, could significantly affect spending for Medicare and Medicaid. Under any of the major proposals considered thus far, however, any savings in these two programs are more than offset by increased spending for other purposes, such as subsidies to allow low-income families to purchase health insurance. Increased revenues may keep health care reform legislation from increasing deficits, but it is unlikely that the adoption of such a plan will significantly reduce them, at least through the next 10 years.

Changes in the Projections

Unlike the report that CBO issued in September 1993, this update does not reflect fundamental shifts in federal spending, revenues, or deficits. Last year's report showed the effects of the enactment of OBRA-93, which reduced deficits by more than $400 billion over five years. Changes from last winter's projections that are reflected in this report amount to a net reduction of just $18 billion over the 1994-1999 period (see Summary Table 4). Legislation enacted since the winter baseline accounts for less than $500 million of that net reduction; changes in CBO's economic forecast and technical estimating assumptions are responsible for the rest.

Changes in the economic forecast reduce projected deficits in the short run (by as much as $8 billion in 1995) and increase them in the long run (by $12 billion in 1999). The combination of higher-than-anticipated economic growth in 1994 and 1995 and increased corporate profits push projected revenues up in all years, but by less in 1998 and 1999 than in the earlier years. The higher interest rates that accompany faster growth drive up net interest expenditures. The increases in projected net interest also decline slightly after 1996, but not as rapidly as the reestimates of revenues decline. By 1998, the increases in net interest costs, together with relatively small increases in other outlays, overwhelm the effect of higher revenues and push deficits up. In any case, compared with some of the large reestimates in previous reports, none of the increases or decreases in any single year represent a major shift.

Changes from the winter projections that cannot be attributed to either legislation or the new economic forecast--so-called technical reestimates--also tend to reduce the deficit in the early years of the projection period (by $18 billion in 1994) and increase it later (by $6 billion in 1999). Technical reestimates increase projected revenues in each year through 1997 but decrease them in 1998 and 1999. Technical reestimates push down outlays projected for 1994 and 1995 but increase them after that. CBO estimates that Medicare and Medicaid expenditures in 1994 will be $4 billion lower than anticipated in the winter baseline. Because it is not clear whether these reductions represent a trend or an aberration in the patterns of Medicare and Medicaid spending, CBO has made no adjustment to the 1995-1999 outlays projected for these two programs. Reestimates of expenditures by deposit insurance agencies are small compared with those in many recent reports but still account for as much as a $5 billion shift in one year. Expenditures for the earned income tax credit (the refundable portion of which is recorded as outlays) are consistently higher through the period than CBO's estimates in the winter baseline. Reestimates in a number of other programs make up the remainder of the revisions in outlays attributable to changes in technical estimating assumptions.

Summary Table 4.
Changes in CBO Deficit Projections (By fiscal year, in billions of dollars)

	1994	1995	1996	1997	1998	1999
Winter Baseline Deficit	228	180	180	192	187	213
Changes						
Legislative changes	a	a	a	a	a	a
Economic assumptions	-8	-8	-5	-2	6	12
Technical reestimates	-18	-10	2	3	4	6
Total	-26	-17	-4	1	10	18
Summer Baseline Deficit	202	162	176	193	197	231

SOURCE: Congressional Budget Office.

NOTE: The projections include Social Security and the Postal Service, which are off-budget.

a. Less than $500 million.

Conclusion

Although a higher rate of economic growth and a lower deficit in 1994 represent good news, the good news is tempered. The recent surge of growth does not herald an improvement in the rate at which potential output will grow. Because the economy is already operating close to potential, an increase in growth above the rate of potential in the short run must be offset by slower growth in the longer run.

Lower deficits in 1994 and 1995 also do not signify any fundamental improvement in the long-term fiscal health of the nation. Under current policies, deficits will begin to rise relentlessly as the decade draws to a close. The current low levels of the deficit should be appreciated as the fruits of the spending reductions and tax increases enacted in OBRA-93. They should not, however, distract policymakers from the need for additional deficit reduction to increase national saving and investment and improve the long-term prospects for the economy.